

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: DeVore and Walters Analyst: Raul Guzman Bill Number: AB 249
Related Bills: See Legislative History Telephone: 845-4624 Introduced Date: 02/08/2005
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Allow Taxpayers With Capital Gains To Use Form 540 2EZ

SUMMARY

This bill would require the Franchise Tax Board (FTB) to make additional types of income reportable on Form 540 2EZ.

PURPOSE OF THE BILL

According to the author's office, the intent of this bill is to increase the number of taxpayers who can use Form 540 2EZ to include those with capital gain income.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative January 1, 2006.

POSITION

Pending.

ANALYSIS

PROGRAM BACKGROUND

California income tax forms are created to fit general demographic categories of taxpayers based on the income and deductions they are most likely to report. The forms range from the most complex, which accommodate any combination of income and deductions, to the simplest, which accommodate income profiles made up of only wages, a small amount of interest, dividend, and pension income, and minimal deductions. Each of these categories serves a large group of taxpayers, and the differences between each form is easy to communicate to taxpayers.

The Form 540 2EZ was designed and first used for the 1999 tax year. The form was a two-sided post-card income tax return with 25 lines of data. It was created to be the state's simplest tax return. Use was limited to taxpayers with the standard deduction and simple sources of income, with no more than three personal exemption credits, and with wage withholding as the only type of tax payments. The Form 540 2EZ uses a special tax table that incorporates the standard deduction and up to three personal exemption credits. Approximately 3 million taxpayers were eligible to use this form in 1999.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	<u> X </u> PENDING

Department Director

Date

Gerald H. Goldberg

3/16/05

In response to a 2002 FTB study, concerns expressed by senior taxpayers, and departmental concerns, the Form 540 2EZ was expanded to an 8 ½" x 11" sheet and revised for the 2003 tax year to include:

- A line for nontaxable items such as U.S. social security and railroad retirement benefits.
- A line for the California Senior Special Fund voluntary contribution.
- A line to report Use Tax for purchases from out-of-state, and.
- Special tax tables and instructions to accommodate the additional personal exemption credit allowed for seniors.

Senate Bill 1534 enacted in 2004 required FTB to revise the "total income" thresholds and to add two income types to Form 540 2EZ.

The "total income" thresholds are as follows:

- For a taxpayer filing as single or as a head of household (HOH), *total income* for the taxable year must be \$100,000 or less.
- For taxpayers filing a joint return or a taxpayer filing as a qualified widow(er), *total income* for the taxable year must be \$200,000 or less.

SB 1534 resulted in two new lines being to Form 540 2EZ, a line for dividend income and a line for pension income. In addition, the instruction booklet increased by 12 pages.

The following represents 2003 and 2004 Form 540 2EZ filing trends using paper returns and E-File.

	2004		2003
Paper 540 2EZ	871,150	-17.9%	1,061,451
E-File 540 2EZ	808,266	+20.02%	673,428

The Form 540 2EZ, 2005 filing trends will be available after May 15, 2005.

STATE LAW

Current state law requires the department to make the tax forms as simple as possible for taxpayers to prepare and allows the department the flexibility to create the simplest, most effective tax return possible. The department is required to design the forms so taxpayers can either copy figures from or attach a copy of their federal returns. The state income tax law for all individuals is largely patterned upon the federal income tax law.

Senate Bill 1534 (Stats. 2004, Ch. 844) enacted specific total income threshold requirements that increased the number of eligible taxpayers that could use the form.

Capital gains or losses are the gains or losses from the sale or exchange of capital assets. The gain or loss is characterized as either short-term or long-term depending on how long the asset was held by the taxpayer.

THIS BILL

This bill would amend the term "total income" to include capital gains along with the existing taxable wages, dividends, interest, and pension income. As a result, this bill would permit taxpayers who have capital gain income, and who meet other existing filing requirements, to use Form 540 2EZ.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation considerations:

This bill would include capital gains as part of "total income; however, the bill is silent on how the Form 540 2EZ should allow for reporting capital gain or loss adjustments for federal/state differences in basis or capital losses. The complications associated with reporting capital gain income may limit the number of individuals who may be eligible to use the Form 540 2EZ as intended by the author since the bill presently would take into account only the gross amount of any capital gains before basis offset and netting of gains and losses.

Assuming that the intent of the bill is to allow basis offset and netting gains and losses of capital gains income, then the following should be considered. Some taxpayers have different capital gain income amounts reported for federal versus state purposes due to a difference in the computation of basis. There are at least 10 different situations where the California basis may be different from the federal basis calculation due to differences between state and federal laws. For example, a difference may exist on the gain from the sale of a personal residence where depreciation was allowed. In situations where there are differences, taxpayers use a separate schedule to determine their California capital gain or loss adjustment. Use of schedules is inconsistent with the purpose of the Form 540 2EZ.

A new line to report capital gains or losses will need to be added to Form 540 2EZ. If a taxpayer reports capital gains or losses on Form 540 2EZ, they would have to attach a copy of their federal schedule D. If the gains or losses were different for state purposes, the taxpayer would have to complete a California schedule D and attach a complete copy of their federal Form 1040. Taxpayers who report capital gains or losses might be subject to Alternative Minimum Tax (AMT) and would also need to complete and attach a California schedule P.

LEGISLATIVE HISTORY

SB 1534 (Johnson, Stats.2004, Ch. 844) added dividends and pension income to "total income," and revised the income threshold requirements.

SB 831 (Poochigian/Johnson, 2001/2002) would have declared the Legislature's intent to direct FTB to issue a tax form that could simplify the filing requirements of certain senior citizens. This bill was held at the Assembly Desk and then returned without Assembly action.

AB 1370 (Wiggins, Stats. 2001, Ch. 266) required FTB to conduct a study of all current tax forms that affect taxpayers who are 65 years of age or older to determine what changes are necessary and appropriate to provide the greatest benefit to those taxpayers. FTB was required to provide the results of the study to the Legislature by January 1, 2002, or as soon thereafter as practicable. The study, *California Tax Forms and Senior Taxpayers Study Report (Assembly Bill 1370)*, was completed and provided in April 2002.

OTHER STATES' INFORMATION

The states surveyed include *Illinois, Massachusetts, Michigan, Minnesota, and New York*.

Review of *New York* tax forms found that individuals making more than \$100,000, or with pension or social security income, are required to file the long form.

Illinois, Massachusetts, Michigan, and Minnesota provide only one personal income tax form that appears to be the equivalent of a California Form 540.

These states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would not impact the state's income tax revenue

ARGUMENTS/POLICY CONCERNS

This bill could potentially increase the number of taxpayers that could use Form 540 2EZ and report capital gains or losses by 174,000 taxpayers.

While permitting a greater number of taxpayers to utilize the Form 540 2EZ, this bill would complicate the Form 540 2EZ for the population of taxpayers for whom it was created.

Allowing taxpayers with capital gains to use the Form 540 2EZ might benefit some taxpayers with otherwise simple tax returns to now be eligible to use the simplified Form 540 2EZ.

The general policy in favor of conformity of California tax laws with federal tax laws allows the California tax returns to be based on the federal tax returns. If the Form 540 2EZ is required to include reporting of capital gains and losses, taxpayers would now have a reportable income item on the Form 540 2EZ that cannot be reported on either the federal Form 1040EZ or the Form 1040A.

The changes that would be made to the Form 540 2EZ by this bill would cause the Form 540 2EZ to resemble Form 540A in appearance, in functionality, and in complexity. Consequently, the simplicity of the form may be defeated.

Allowing additional taxpayers to use the Form 540 2EZ would run counter to FTB's strategic plan by expanding a paper filing option when the department's long-term strategic goal is to encourage taxpayers to e-file. To achieve this goal, FTB tries to expand e-file by adding improvements, services, and options to enhance the taxpayer and tax professional's tax filing experience. This bill could result in thousands of additional taxpayers filing a paper Form 540 2EZ at a time when the department is encouraging electronic filing.

LEGISLATIVE STAFF CONTACT

Raul Guzman
Franchise Tax Board
845-4624
raul.guzman@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov